

## **CORPORATE GOVERNANCE AND CONTROL IN BULGARIA**

### **Summary Report**

At present, a few countries in the world can afford to ignore the problems related to corporate governance and control, still more if they are aiming to attract foreign investment. This is quite true for the transitional economies as well. The good corporate governance and control guarantees a benefit for shareholders, restrict the abuses and corruption, and, finally, it is a guarantee for economic growth and social progress.

The positive point is that Bulgaria is also a part of the global process of theoretical discussions and practical initiatives to apply the best world standards in the field. Until recently, "corporate governance and control" were an abstract and incomprehensible concept not only for the mass of individual shareholders who acquired ownership through mass privatization, but also for the representatives of state institutions and private business. As of today, the importance of the problem particularly for an economy whose restructuring is an urgent need is realized on the highest governmental level. During the last years, meetings and discussions, education seminars and sociological surveys were organized and the first more serious editions on the issue were published in Bulgaria, all of them supported by the active efforts of the professional community and media. A proof for Bulgaria's striving for searching an answer to the global problems in the field of corporate governance and control is the inclusion of the issue in the program of this year's Investment Forum for South-East Europe (18<sup>th</sup>-20<sup>th</sup> October, 1999, Sofia).

This report is aiming at presenting the state and specific problems of corporate governance and control in Bulgaria. It has been elaborated as part of the project "Corporate Governance Initiative in Bulgaria" with the financial support of the Center for International Private Enterprise, an affiliate of the U.S. Chamber of Commerce. The project is mainly targeted at facilitating the introduction of contemporary standards of corporate governance and procedures that are to guarantee responsibility and accountability, transparency in the economy and control mechanisms within companies.

The report has been drawn on the basis of data from sociological surveys (carried out by Vitosha Research Agency for the Center for Economic Development) as well as publications of international organizations and specialized editions. The conclusions for Bulgaria presented in the report are based on the information from a qualitative sociological survey on the corporate governance problems. The survey was carried out in late January 1999 using the discussions-in-focus-groups method. Participating in the discussions were representatives of branch ministries, the Privatization Agency, Center for Mass Privatization, Securities and Stock Exchanges Commission, Bulgarian Stock Exchange - Sofia, managers of enterprises and investment companies, investment intermediaries, investors, organizations, individual shareholders, journalists.

The basic empirical data presented in the report are a result of a quantitative sociological survey carried out in the autumn of 1998. The sample covers 52 enterprises with more than 100 employees, a value of assets owned exceeding Levs 20 million (as of December 31<sup>st</sup>, 1995) and privatized prior to the end of 1996.

The report presents an analysis of the core problem areas of corporate governance in Bulgaria during a period when the predominant number of enterprises and approximately half of the assets were privatized. Apart from diversifying the forms of ownership, the privatization of state-owned enterprises also denotes a necessity in new mechanisms for control over managers and coordination of owners' interests. The ambition is to identify the specific peculiarities of corporate governance and control for transitional economies on the example of Bulgaria, that are supposed to require adequate measures for overcoming the specific problems.

## **1. Obscurity of the concept and terminological difficulties**

The discussions in the focus groups confirmed the hypothesis that a commonly accepted understanding of the contents and scope of corporate governance has not yet been shaped and approved. Differences were ascertained in the interpretation of the "corporate governance" concept even on experts' level. A typical illustration of absence of a commonly accepted understanding of corporate governance is its repeated mixing with the strategic and operational management. In a number of cases, the concept's scope includes also elements such as personnel (human resources) management, realization of production, financial management, etc. The related difficulties are manifested also in the "terminological insufficiency" ensuing from the use of a single concept "governance" that is given different meanings. For the wide public presented in the discussions by individual shareholders and media representatives, the problems of corporate governance are solely brought forward in a practical aspect, without searching for their conceptual basis.

At present, corporate governance in Bulgaria is most often interpreted as governance of relationships and coordination of interests between owners (principal) and managers of corporations (agent). A specific detail is the addition that corporate governance also concerns the relationships between various categories of shareholders having specific interests and, most often, unequal possibilities for exerting influence on joint-stock companies. The scope of corporate governance also includes the issues of management structure, rights and responsibilities of managing bodies of joint-stock companies as well as the inside relationships within the managing bodies (e.g. between inside and outside directors).

Standing out, as a specific element of corporate governance in the transition process in Bulgaria, is the role of the state in the process of corporate governance both as being responsible for creating the common legal and regulatory and economic conditions whereon corporate governance is being implemented, and a specific subject of these relationships. In practice, the contents of the concept "corporate governance" in Bulgaria do not usually include the relationships with the stakeholders, i.e. customers, suppliers, the local communities. A connection between corporate governance and the role of banks within it is made very rarely.

## **2. Ongoing restructuring of corporate ownership**

Most of the Bulgarian enterprises are relatively small and most often they prefer the model of the limited liability company rather than the joint-stock company. Today, most of the joint-stock companies in Bulgaria are a product of their mass transformation with a view of their upcoming privatization, and not of the natural development of market mechanisms. This is the heart of the most serious challenge to them during the transitional period. They have to establish and strengthen their corporate structure and introduce efficient mechanisms of corporate control within a short time.

A considerable number of enterprises privatized under the mass privatization scheme, and former privatization funds have already been granted a status of public companies. The new model of corporate ownership with various schemes of interaction of capital (private and state) as well as the status of a public company are the ground for development of corporate governance and control in Bulgaria. The development of corporations and formation of public companies in particular in Bulgaria is not always subordinated to the economic necessity but is subject to administrative and legal measures. This is a serious obstacle to the establishment of principles of corporate governance and control.

At present, the joint stock companies do not yet have serious economic motivation to apply the principles of corporate control, nor a created corporate culture. This forms the idea of "artificiality", "compulsive nature" and "inefficiency" of the legal and regulatory rules within the experts' community.

The ongoing changes in the ownership structure are also exerting negative effect (in the sense of indefiniteness) on corporate governance in the Bulgarian firms. Unlike many ex socialist countries, Bulgaria does not suffer from the deformations in the ownership structure occurring often in the said countries, i.e. excessive dispersion of ownership resulting from mass privatization and considerable shareholders participation of investors being inside to the firm (employees and managers).

According to data from the quantitative sociological survey, the most significant category of owners in the Bulgarian enterprises after the privatization are the local legal entities (23%) and privatization funds (19%). Follow the present employees and managers of the company and ex personnel (24%) and foreign investors (10%). The state is still an owner of 18% of the enterprises under survey.

A characteristic feature of the ownership structure is the high degree of ownership concentration. In 60% of the companies, a strategic investor owning over 50% of stock is present. In 32% of the companies under survey, this investor owns over two thirds of the ownership, that guarantees an entire control of the investor over the management. In the remaining 21% of the companies, the biggest investor cannot influence the management since the former owns less than one third of the stock. At the same time, not more than three among the biggest investors are holding the controlling stock interest in 87% of the joint stock companies.

As a result of privatization and transformations in the ownership in the Bulgarian companies surveyed, four basic models of ownership structure are formed. The first and most often occurred (55% of the companies) is the one with predominant participation of the outside local investors in the ownership, where in 25% of the companies these are privatization funds, and in 30%, other Bulgarian legal entities. The second model is the one with predominant participation of employees and managers in 21% of the enterprises surveyed. The third model is with predominant participation of outside foreign investors (12%), and the fourth model is the one where none of the subject of ownership has more significant participation (12%).

In 64% of the enterprises in the sample under survey, a one-tier system of management is applied, and a two-tier system is applied in the remaining 36%. As a whole, the staff of the managing bodies of companies corresponds to their ownership structure. Yet, persons being related in one way or another with the state very often represent the companies. It is expected that the restructuring of ownership in the line of its concentration (especially in the former privatization funds) and final withdrawal of the state from its role of an owner will be completed in the near future.

From a point of view of the ownership structure, the prospects for applying the contemporary corporate governance and control in the Bulgarian reality can be estimated as good. No serious difficulties are to be expected in coordinating the interests and standpoints for development of business of various groups of owners. A much more serious problem is how to overcome the short-term thinking and behavior of owners and managers by means of corporate governance mechanisms.

### **3.Realization and protection of shareholders. rights**

As a result of the mass privatization program, some 3.5 million Bulgarian citizens became owners of financial instruments during the period 1996-1997. (The total number of adult citizens is some

6.5 million). Some 3 million citizens are owners of shares of 81 privatization funds, and some half a million citizens are owners of shares of 1,050 companies proposed in the program.

These individual shareholders whose number is enormous on the strength of mass privatization are usually not quite aware of their rights and responsibilities and have not sufficient experience in their exercising. The realization of their rights is impeded by deficiency of financial resource and unwillingness of the management to work for the shareholders' benefit. The motivation and interests of individual shareholders are too weak.

Under these circumstances in Bulgaria, the individual shareholders seem to be passive in most cases. At present, their role is considered to be peripheral and economically subordinate. Still, they are not thought of as a source of financial resource but are rather perceived as a problem and not a possibility. Regardless of the skeptical attitude towards the individual shareholders at present, the expectations are for continuous increase of their significance as a source for accumulating a financial resource in the future. Their activity as a participant in corporate governance is to be manifested. Unlike the USA and Western Europe, these shareholders in the Central and East-European countries will probably be more active because of their ambition to "make up for the missed time" and the smaller average size of enterprises within the region.

The issue of the most adequate way of protecting the interests of minority shareholders has not yet been solved within the Bulgarian environment. There has not been sufficient practice on the realization and protection of the rights of minority shareholders. On the one hand, the legislation regulates the shareholders' rights to exert influence on the management and prevent serious violations on the part of the managers. This will be achieved to a maximum extent by the forthcoming adoption of the Law on Securities by the National Assembly. Discussed were also proposals for legal regulations allowing voting via mail, cumulative voting, etc. At the same time, there are still numerous organizational and bureaucratic obstacles to the entire realization of the rights of minority shareholders - participation in the general meeting of shareholders, representation in the managing bodies, receiving dividends and so on. One cannot sufficiently rely on the judicial system since it intervenes slowly and not always professionally in settling disputes related to corporate governance and control. In such an environment, it is difficult to protect the shareholders' rights and provide, at the same time, the required degree of freedom of managers under an underdeveloped institutional basis that has to clearly define the relationships between owners and managers.

This is the situation where an acceptable balance between the interests of shareholders and managers has to be found. Besides the legal regulations, numerous other measures aiming to convert the individual shareholders into "active" owners will be of high significance. They include education and support by NGOs, public awareness campaigns with the participation of all interested parties, disclosure of positive examples through media, etc.

#### **4. Composition and behavior of managing bodies**

Another issue of importance for corporate governance and control, having specific dimensions related to the transitional period, is the following: who are the members of company's managing bodies and what is their role for restructuring and determining the trends of company's development? This is the point where one should also trace out whether the requirements for representativeness and team-operation in governance, transparency and responsibility in the work of managing bodies are adhered.

In Bulgaria, these aspects of corporate governance and control have not yet been entirely perceived and are realized in insufficient degree in practice. There is no empirical information for determining what is the role of company's insiders and outsiders and whether there is a balance

between them in the managing bodies. The issue of the motivation of operational management to work for company's interest and all shareholders has been investigated insufficiently as well.

Like the other former socialist countries, the structure and personnel composition of corporate governance bodies in Bulgaria were not formed completely. Data from the sociological survey is pointing out that representatives of the former owner, i.e. of the state, are members of the corresponding boards in more than a half of the companies. They are present even in 20% of the companies with a foreign investor. On the one hand, this fact is an evidence for the ambition of the state to continue influencing the privatized enterprises, and on the other one, it evidences that, in the best case, in most of the enterprises the inertia of the past and dependence on the state authorities has not yet been overcome. In the worst case this might be a manifestation of some form of corruption.

The next big group of members of the supervisory boards/boards of directors are the owners - company's insiders. They are present in 44% of the companies and mostly in those with predominant ownership of employees and managers. In 36% of the companies, there are also representatives of Bulgarian legal entities (without privatization funds), and in 22% of the companies, there are representatives of privatization funds. A summary of these data from a point of view of the dominating positions of any of the groups will give the following result: in 66% of the companies under survey, the boards are dominated by outside representatives not related to the state; in 24%, by inside representatives (employees and managers), and in 10%, by outside representatives related to the state.

This aspect of corporate governance in Bulgaria should also concern the problems of relationships between the owners and representative managing bodies appointed by the former and the executive bodies of management - first of all, the executive directors. The role and function of these main subjects whose relationships are regulated by corporate governance have not yet been defined and differentiated clearly in Bulgaria. This is the ground where conflicts arise and the existing practice deviates from the principles of corporate governance.

The executive directors have not yet been adjusted to subordinate the governance of joint-stock companies to the owner's interests. Usually, they do not perceive their obligations to work for the interest of the company and its shareholders, but led by the heritage of the past, they are acting as sole owners or serving the interests of some of major shareholders. This model of governance is assessed as a rather steady one, thus impeding the establishment of principles of corporate governance. Sometimes, the executive managers succeed in affecting strongly some of the shareholders (e.g. workers and employees) under a threat of dismissal, and even some of company's outsiders by allowing them no access to information being of importance for the company.

The present situation is, to a great extent, a consequence of the continuous absence of efficient control on managers due to the delayed privatization, permanent instability of the management teams, presence of a common environment and mechanisms motivating a kind of managers' behavior that favors them for the account of the companies managed by them. In Bulgaria, there are still no satisfactory regulations on the problem related to the "conflict of interests" and such occurrences are not subject to sanctions. A serious problem is also the objective lack of knowledge and experience for work in a market environment. The attempts to bind the managers' remuneration to the achieved economic results (e.g. by payment of a bonus to the executive directors as percentage of the realized profit) are not always effective. Pressed is the view that the lawful economic incentives do not have the motivating force of the personal interest that is often formed out of the framework of the legal economic practice.

In conclusion, it should be noted that also in Bulgaria the most part of the former executive managers of companies, who preserved their positions after the privatization as well, will continue to be opponents to the restructuring and establishment of a new type of relationships with the

owners. Besides, the privatization funds in Bulgaria changed 3-7% of the managers of enterprises upon the completion of the first round of mass privatization. (In comparison with the Czech Republic, this percentage is within the limits of 80-90%.)

The gradual introduction of the corporate governance standards in Bulgaria will also contribute to the creation of a new type of managers - having knowledge on the market economy and with the proper respect and skill for working with the shareholders and stakeholders. Also, we are speaking of managers being acquainted with, and using the capital markets, who will contribute to the observance of rules of accountability and transparency. The use of methods such as disclosure of information about the remuneration of managing bodies and executive directors, structuring of auxiliary bodies such as a remuneration committee, an appointment committee, and an internal audit section will significantly improve the corporate governance practice. There is also a necessity of brising up the efforts for education and enhancement of the advanced vocational training of the members of companies. managing bodies and executive managers.

### **5. Corporate governance and capital market**

In Bulgaria, the interconnection between the application of principles of corporate governance and development of capital markets is perceived increasingly. The approval of professional standards of corporate governance is a prerequisite and a significant stimulus for development of capital market. These are of a particular importance for maintaining the investors. trust and guaranteeing the market liquidity. The feedback (capital market - corporate governance) is also making its way. The capital market is an extremely important control mechanism that evaluates the corporations and selects those of them that are governed skillfully and are running efficiently.

At the same time, there are numerous factors impeding the potential possibilities for implementation of this kind of interaction. The predominant experts. assessment is that at present the capital market in the country is still in an embryonic state and stagnation. It is existing mostly as a secondary market and does in practice serve mostly the reallocation of ownership. The expectations are pointing out that without development of the capital market that could allow raising of financial resources under favorable conditions, the capital market in Bulgaria will play an insignificant role.

There is no confidence among the investors that the resources provided by them will be governed efficiently. On the one hand, this is related to the inefficient application of principles of corporate governance, and on the other one, to the limited and inaccurate, in many cases, information being submitted on the state of public companies.

Most part of joint-stock companies that are granted a statute of "public companies" are not interested and willing to maintain this statute. To them, this is related with administrative pressure and supposes considerable expenditure without getting economic benefit in return.

Even in cases where an interest in issuing stock and bonds is manifested, the state in the person of the Securities and Stock Exchanges Commission is often imposing a restrictive policy. At experts. opinion, a striving for "overregulation" is demonstrated, that appears to be an additional obstacle to the development of the primary market.

A demotivating factor for investing in stock is also their low liquidity. This does not allow to actuate the control function of capital market as well since the shareholders do not know for certain that they are in a position to impose sanctions on eventually inefficient governance of joint-stock companies.

During the post-privatization period in Bulgaria, the capital market will further increase its active role for restructuring of enterprises (property rights and control rights). It is to be implemented

exclusively on a market basis by the managers who are feeling threatened by the owners, as well as by takeover. The efficiently operating capital market may play an important role for disciplining the managers and finding an objective market evaluation of their activity's results.

Through the capital market, the mass privatization participants who are not willing to remain owners, should have the possibility to relieve from their shareholdings under fair conditions, thus consolidating additionally the ownership and improving the corporate governance. Restructuring of strategic and institutional investors. portfolios will continue as well. The developed and liquid capital market in Bulgaria will forward the companies. stock to the most efficient structure of ownership and concentrate the ownership among the most efficient investors.

## **6. Transparency and disclosure of information**

The establishment of statutory rules and a mechanism for granting a free, fast and inexpensive access to information about the state of joint-stock companies is a key condition for realization of the remaining principles of corporate governance as well.

All participants in the focus-groups discussions are sharing the view that transparency and access to information as of today are extremely restricted. Violated is even the statutory requirement for publishing the annual balance sheets of joint-stock companies. Managers of enterprises declare that they are providing information about the companies. state and activity quite reluctantly and only when required to do so within their statutory obligations.

It is paradoxical that a large volume of information being one and the same in most cases, is gathered by various institutions. At the same time, the subsequent access to it appears to be extremely difficult that makes the efforts for its gathering rather senseless.

The public companies which, by definition, have to guarantee maximum transparency about their activity, do not realize in practice this basic principle of corporate governance.

The main reason for this state is to be searched in the joint-stock companies. lack of motivation to provide information. First, absent is the important motive that providing information to the wide public will make possible to attract a financial resource. Providing information to the wide public has not been motivated by a real economic interest but rather by a statutory and administrative pressure. Second, there are fears that the information might be used against the organization. s interests. Third, expressed are opinions that the enterprises are not interested in providing a comprehensive and reliable information, that is manifested, in some cases, in the differences between data submitted by tax administration, on the one hand, and the National Institute of Statistics, on the other one.

Transparency on the state of public companies cannot be obtained through administrative pressure even when required by law. The stipulated sanctions when are not supported by economic motivation fail to be efficient.

During the last months, a noticeable progress was achieved along these lines in Bulgaria. The Securities and Stock Exchanges Commission is working actively for providing a fast and inexpensive access to information about the public companies. The most suitable way to do so is the electronic form of the unified register. Information has to be received operatively and in a form allowing for making an analysis and summaries.

Particularly important is also the necessity in providing adequate information to the small individual shareholders. The availability of comprehensive and reliable information about the state

of companies whose shares they are holding, is the most reliable mechanism for protecting their interests. The confidence in the joint-stock company and expectations for receiving a yield exceeding the average rate of interest appear to be the main motives for the investor. From this point of view, the reliable information about the existing risk and expected yield on share purchase are a paramount element of the information searched for.

## **7. The role of former privatization funds in corporate governance in Bulgaria**

The program for the first round of mass privatization in Bulgaria envisaged the participation of privatization funds in their capacity of institutional participants. To this end, 81 privatization funds were registered and licensed then by the Securities and Stock Exchanges Commission. The specific conditions for their establishment, their characteristics and regulation of their activity are of a great importance in the long run for the development of companies in which the participants hold shares as a result of mass privatization. Their influence on corporate governance and perspectives for companies. restructuring is mostly dependent on the relative share of their ownership in privatized enterprises and their own long-term strategy. The already former privatization funds themselves are also an interesting example for application and development of corporate governance mechanisms.

As a result of the program for the first round of mass privatization, about 3 million citizens are holding shares in 81 privatization funds, whose total face value is about Levs 60 billion. The privatization funds themselves are owners of diversified portfolios of shares of totally 1,050 companies. Upon completion of the program, the most part of former privatization funds were transformed into industrial holding companies, and their single representatives, in investment companies.

Unlike other countries in Central and Eastern Europe, Bulgaria is short of sufficient empirical information from specialized surveys dealing with the behavior of privatization funds during the post-privatization period, as well as surveys tracing through the problems of corporate governance in the funds themselves. The influence of privatization funds on the development of corporate governance in Bulgaria is going to be manifested in full strength and evaluated within a few years. But even now one can assert that they are meeting, to a great extent, the requirements for providing a high concentration of capital and ownership, efficient control over operational management and professional management oriented to purely economic aims.

The aims they set themselves and their behavior during the post-privatization period are pointing out that they are acting rather as a strategic than a typically institutional investor. The insufficient experience and training of the members of managing bodies of their subsidiary companies appeared to be a serious problem for former privatization funds. This brings forth the urgent need of additional training and skills enhancement. The significance of the purely market mechanisms for employing adequate personnel with proper experts. knowledge and managerial skills will become stronger as well. There are also difficulties in the relationships with the executive directors who are taking away the most managerial functions. It is still hard to overcome the weak personal interest and lack of understanding of shareholding relationships on the part of workers and employees who have received minimum blocks of free shares through mass privatization.

Serious problems related to corporate governance are also emerging in the cases when certain privatization funds are controlled by managers of the main companies in their portfolios, i.e. inside shareholders are controlling the enterprises. The outside shareholders (the holders of shares in the privatization fund) are a very incompact group to exert significant influence. There are also omissions in the regulatory enactments, the regulation and infrastructure of capital market, that make possible the abuses and violations of the rights of shareholders of former privatization funds.



## **8. Specific role of the state in corporate governance**

At present, numerous enterprises are still experiencing an extremely unpleasant precedent of partnership between the state and private shareholders. In many cases, the state is still a majority shareholder but its shareholding exceeds insignificantly that of the remaining shareholders, and finalizing of privatization procedures is at hand. In even more cases, the state is a minority shareholder, i.e. the state is getting for the first time into a situation where it is just one of the shareholders, and not the owner.

Under this situation, the state representatives are demonstrating several types of behavior. They are either disinterested in the enterprise and do not participate in its governance at all, or the state-appointed representatives are easily talking at a common ground with private shareholders to the prejudice of the state in its capacity of a shareholder. Finally, they often abuse of their capacity of state administration representatives and interfere beyond their authority of a shareholder. All of these cases bring forth conflicts whose settlement has to be sought for in the strict observance of corporate governance principles.

During the process of transition until the state retires in practice from the enterprises or in cases where the state will maintain for a while a noticeable or majority participation in large-scale enterprises of service sector infrastructures, it is very important to specify the essence of corporate governance through adequate forms of training and continuous dialogue with state authorities. Probably, it is not still late to elaborate and approve the adequate regulatory enactments on state participation in corporate governance, that will be in conformity with the transformed structure of ownership.

The state intervention in the functioning of private economic entities creates a situation favoring undesirable informal commitments of companies with civil servants and often unnecessary politicizing of decisions being economic in essence. This will be overcome by the completion of the privatization process in broad outlines and establishment of a common public policy on the issue of state shareholding. As the analysis points out, in Bulgaria there are still missing approved rules and practice to exercise efficient corporate governance and control. For the present, the regulatory framework and entire institutional environment have not found a system that can provide efficient governance of ownership to the benefit of all shareholders. The efforts of the Corporate Governance Initiative to prepare and discuss, as broadly as possible, the Policy Recommendation Paper - Policy for Corporate Governance Development in Joint-Stock Companies in Bulgaria, are an attempt to foster these processes in Bulgaria.